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BEFORE THE ARIZONA CORPORATION COMMISSION

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CARL J. KUNASEK
COMMISSIONER

Arizona Corporation Commission
DOCKETED
JUN 26 1996
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INSTRUMENT CONTROL

IN THE MATTER OF COMPETITION IN THE)
PROVISION OF ELECTRIC SERVICES)
THROUGHOUT THE STATE OF ARIZONA)

DOCKET NO. U-0000-94-165

NOTICE OF FILING

The Arizona Utility Investors Association hereby files its response to the Arizona Corporation Commission's "Request for Comments on Electric Industry Restructuring" dated February 22, 1996, in the above-captioned docket.

DATED THIS 26TH DAY OF JUNE, 1996.

Walter W. Meeke
WALTER W. MEEK, PRESIDENT

Original and ten (10) copies of the foregoing Response filed this 26th day of June, 1996, with:

Docket Control
Arizona Corporation Commission
1200 W. Washington Street
Phoenix, AZ 85007

Copies of the foregoing Response were hand-delivered this 26th day of June, 1996, to:

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RESPONSE OF THE ARIZONA UTILITY INVESTORS ASSOCIATION TO THE ARIZONA CORPORATION COMMISSION'S REQUEST FOR COMMENTS ON ELECTRIC INDUSTRY RESTRUCTURING

Preface

Among the options listed for introducing retail electric competition, a pilot program is not the method favored by the Arizona Utility Investors Association. The investor's goal is to achieve controlled but steady progress toward a competitive market which can be leveled off if the market signals that it has reached saturation or equilibrium in terms of efficiency. Thus, the option we prefer is phased-in competition.

Achieving full competition by force majeure could result in financial chaos and the devaluation or loss of utility assets. On the other hand, a pilot program is experimental, does not lead to a permanent result and creates uncertainty.

In addition, we do not believe that a pilot program can create the conditions that are requisite to making the fundamental political, financial and structural changes that may be necessary to achieve a competitive market. For example:

1) Assume that a regulated company, faced with a definitive timetable for phasing into competition, might conclude that it must make basic changes in its business, including perhaps divesting certain assets or separating its business units. This could be a lengthy and expensive process which could not be initiated in response to a pilot program.

2) In a competitive world an industrial customer would have to examine an array of options and market conditions that could vary significantly in terms of capital cost and long term commitment. Some of these options could never come into play under the terms of a pilot program which would necessarily be restricted to buy-throughs or purchases on the open market.

3) Putting regulated and non-regulated entities on the same competitive footing may require action by the Arizona Legislature, rule making by the Commission and a number of other complex financial and structural adjustments by the utilities. Again, these actions probably would not be initiated, much less concluded, in response to a pilot program.

Thus, AUIA's view is that a pilot program would stall decision-making and delay progress toward a competitive market. Therefore, where it is feasible to do so in our responses we distinguish between a pilot program and a phased-in transition; otherwise, we assume that the phase-in is the preferred concept.

A1. Affected Utilities. *Which utilities should open their markets to competition?*

Ultimately, every electric customer in Arizona should have the same opportunity to be served from competing sources. That means that every electric utility -- private, government and tribal -- should open its market to competition. However, two prerequisites are: that the market will be free of distortions imposed by government; and that any provider who wishes to offer competitive service in an otherwise exclusive service territory must conduct that portion of his business under Commission jurisdiction during the transition to a free market.

In the case of a pilot program, only entities which are already under ACC jurisdiction could participate, leaving Salt River Project and other providers which are not public service corporations out of the program. In our view, this would distort and perhaps invalidate the results of a pilot program. Furthermore, we question whether electric cooperatives should participate in a pilot program because they could suffer irreversible economic damage (see Q. A3c.).

A2. Scope of Restructuring

a. How much of the utilities' markets should be opened to competition?

Eventually, 100 percent of each utility's market should be open to competition. Presumably, a pilot program would include a finite number of relatively large customers. In a phased transition the market segments would be subject to the phase-in schedule.

b. Which consumers should be allowed to shop around for power and energy? Consider both geographic and consumer classes.

In the end, all consumers should be available to the competitive market. The focus of a pilot program would depend on the distribution of large industrial loads among participating utilities but should include firm requirements no smaller than 1mW and probably should focus on loads of 3mW and larger.

c. Should utility customers served under existing contracts be eligible to participate in the competitive market prior to expiration of the existing contracts?

No, unless both parties to the contract are willing to abrogate it.

d. If divestiture were undertaken, how should it be accomplished?

Divestiture is not applicable to a pilot program. In other circumstances it should only be undertaken voluntarily and with the approval of the Commission. As a regulated company seeks to divest facilities or unbundle or spin off its services, the Commission should provide oversight to be assured that the entity remaining under regulation is positioned financially and otherwise to carry out its service responsibilities.

A3. Term of Restructuring

a. When should competition start?

A reasonable target date for the start of competition is about the year 2000. This allows time for several pending developments: 1) completion of the Arizona legislative study of electric competition; 2) Congressional action to take shape; 3) experience with FERC rules regarding open access; and 4) reconfiguration of bulk power markets.

b. If competition is in the form of a pilot or phase-in, how long should the pilot or phases run? Please describe the phases of a phase-in. Please consider that many larger customers of utilities are currently under contract and may not be able to shop around until those contracts expire.

A phased transition should segment the utilities' industrial and large commercial customers into consecutive two-year increments according to load size. We leave it to the Commission and the companies to determine the maximum number of customers and/or load limits for each phase, but the phase-in probably could be completed in four years. This should give the Commission time to: evaluate market conditions and transaction costs; get a handle on stranded investment; determine whether and when competition should be extended to include smaller users; and develop rules and regulations for the broader consumer market.

In our view, the term of a pilot program would have to be long enough to allow large customers to participate, bridging existing contracts and allowing new transactions enough duration to simulate reality in the marketplace. Allowing for existing contracts to expire and a reasonable duration for new ones could stretch a pilot program to eight to 10 years.

c. If competition is in the form of a pilot, how can the term of the pilot be set so as to avoid discouraging long term contracts signed under the pilot?

A-pilot program should attempt to simulate reality for the participants. We have discussed duration in (b.) above, but we can add some further thoughts. Although the Commission probably has the authority to enforce the terms of a pilot program, AUIA believes it would be difficult to abrogate any perceived gains achieved by customers in a pilot. In other words, a customer lost during a pilot program may be lost for good in circumstances in which the utility has not been able to implement a long term competitive solution.

A4. Services Available on a Competitive Basis. Which services should be available in a competitive market?

- *Distributed energy services (serving multiple consumers).*

No, at least not in urban load centers. There is nothing about the advent of retail wheeling that makes this a desirable option. For years, utilities have moved power plants away from load centers and now it is proposed to bring them back in small pieces. In terms of land use and aesthetic and environmental impact, this is the energy equivalent of the septic tank subdivision, and the results could be absurd.

- *Central station generation services at market based rates.*
Yes.

- *Other services described in A5, A6, A7 and A8.*

Nearly all of the services described in A5, A6 and A7 could be offered competitively in an open market or negotiated in bilateral contracts. The exceptions are transmission and distribution services which will continue to be regulated. Where competitive markets exist, these services may be priced at market rates, but where there is no competition prices will be based on cost. In an Arizona context, AUIA believes that essential utility services should remain integrated and that services which are related to system reliability should be provided by the transmission operator. Further, there are some customer services which are integral to the distribution system and for the sake of efficiency should not be unbundled and priced separately.

- A5. Necessary Services.** *Utilities and perhaps other parties will have to address the services listed below. Please indicate how these services should be offered, measured (metered) and priced on an unbundled basis.*

AUIA is not prepared to discuss how these services should be measured and priced.

- A6. Market Center Services.** *The market may benefit from the services listed below. Please indicate how these services should be offered and priced.*

AUIA is not prepared to discuss how these services should be offered and priced.

- A7. Spot Market Services.** *The market may benefit from the services listed below. Please indicate how these services would be offered and priced.*

AUIA is not prepared to discuss the pricing of these services.

- A8. Transmission Service.** *For a competitive market to work, utilities owning transmission facilities must provide transmission service. Please indicate how the following objectives would be met.*

- *consistency with FERC tariffs.*
- *comparable services*
- *interconnection agreements*

Beyond the plain language of these objectives, AUIA claims no expertise in providing transmission service.

- A9. Recovery of Stranded Investment.** *Please indicate how the recovery (if any) of stranded investment should be accomplished. Address each of the following issues:*

- a. The definition of stranded investment.*

Stranded investment is any investment, cost or expense which was prudently incurred in order to meet the utility's obligation to serve its customers and which, as the result of a regulatory action or policy, becomes unrecoverable through tariffed rates and charges.

- b. The fraction of stranded investment which should be recovered.*

Based on the foregoing definition, 100 percent.

- c. How the Commission will determine the amount of stranded investment.*

AUIA believes it is premature to arrive at a precise method for determining stranded investment until there is better definition of the market for retail competition and its impact on regulated companies. It is appropriate for the Commission to adopt a policy statement that it is the Commission's intention to allow 100 percent recovery of prudently incurred costs when it is appropriate to make that determination. In addition, the policy should indicate that the companies should begin to take action to mitigate stranded investment.

There are two basic approaches to stranded investment. One is the global approach which requires a comparison of the book value and market value of the assets with the difference converted to a non-bypassable charge applied to customer bills. Obviously, this approach requires some method, ranging from a forced sale to an appraisal, to establish market value. It may also require an adjustment mechanism to protect against market changes during the repayment period if the utility retains ownership of the asset.

The other approach is incremental. If competition is accomplished through a phase-in, then those customers who choose to leave the system can be required to continue contributing to the utility's fixed costs for some period of time, perhaps until their load is replaced on the system. As the phase-in progresses, it may become more apparent whether a global approach to stranded investment will be necessary and how it should be accomplished.

AUIA believes that stranded investment could pose a major difficulty in a pilot program. While a large user might be willing and able to absorb an exit fee or some other non-bypassable charge as part of a long term approach to his energy needs, it may not be feasible under the limitations of a pilot program. At the same time, the utility cannot forego recovering its stranded investment in a pilot program. If recovery is deferred, it creates another category of regulatory assets.

d. Preliminary estimates of the magnitude of stranded investment.

AUIA has no particular expertise for quantifying stranded investment and will have to rely on the best efforts of others. If one accepts the rather arcane methodology of Moody's Investors Service (August 1995), the two largest companies under Commission jurisdiction, APS and TEP, have potential stranded investment of \$1.5 and \$1.2 billion respectively. The Moody's method included a present worth calculation of regulatory assets amortized over 10 years.

However, the Commission and APS have agreed to amortize \$1.3 billion of APS's regulatory assets over eight years. Assuming that the amortization is actually achieved concurrent with or ahead of the advent of retail competition on a large scale, then the Moody's estimate for APS would drop significantly but probably not as low as \$200 million.

More recently, Prudential Securities has issued its estimates of stranded investment using a different methodology. Based on a 10-year transition starting in 1998, Prudential estimated annual revenue losses in industrial and commercial sales, assumed 75% recovery through approved transition charges, then assigned a present value to the remaining losses. This produced estimates of \$337 and \$142 million for APS and TEP respectively.

e. The proper ratemaking treatment of negative stranded investment.

Rate reductions or customer credits, depending on the magnitude and the nature of the investment. In the case of differing results for assets on the same balance sheet, one result would offset another in reaching the final result.

f. From whom stranded investment should be recovered.

To the extent possible, stranded investment should be collected from those who cause it. This would be more achievable in a phased-in transition and where divestiture is not required.

g. The mechanism for recovery of stranded investment.

As discussed above, the mechanism in a phased-in transition could be an exit fee or some other revenue replacement mechanism. In a global approach in which all of a company's assets are in question, the entire customer base would have to share in the result, including new customers and departing customers.

h. The time period over which stranded investment is to be recovered.

Moody's and Prudential based their calculations of stranded investment on a 10-year transition period. One paramount objective in establishing an appropriate recovery method would be to facilitate rather than inhibit competition. Depending, of course, on the size of the problem, the period would probably fall somewhere between six and 10 years. In any case, the period should be the same for every entity under ACC jurisdiction even though the amounts would differ.

i. How utilities can mitigate stranded investment.

Primarily by reducing operating costs to position themselves to be as cost competitive as possible as soon as they can. In addition, utilities can also increase sales and leverage those increases by accepting a lower rate of return and they can use a portion of their net revenues (earnings) to more quickly amortize their assets as APS expects to do with its regulatory assets.

A10. Recovery of Costs of Commission-Mandated Utility Low Income, DSM, Environmental, Renewables and Nuclear Power Plant Decommissioning Programs ("Mandated Programs").

a. How shall costs of mandated programs be recovered from participants in the competitive market?

AUIA does not necessarily agree that all of such programs should be "mandated" in a competitive environment. Furthermore, it is at least possible that the only entities which will continue under regulation will be distribution companies (DISCOS), and an argument can be made that DISCOS have no inherent responsibility for DSM, environmental, renewable and decommissioning programs. To be more specific:

- In our view, the market should be allowed to determine which DSM programs should survive and who should provide them.
- Decommissioning programs are an issue between the NRC and the utility companies or their successors in interest. The NRC has opened an inquiry into this matter to determine how it can assure continued responsibility for decommissioning in the face of restructuring.
- Low income programs should either be delegated to the Arizona Legislature as a matter of social policy or handled under a universal service fund which would be supported by every provider of electric services under the Commission's jurisdiction.
- The efficacy of environmental and renewable resource programs will probably depend on the Commission's resolve. In order to be equitable, the cost of these programs should be spread among all electric competitors under the Commission's jurisdiction, although it is unclear who would be responsible for implementing them unless the utilities continued to be vertically integrated.

b. How shall the magnitude of the costs of mandated programs be determined?

Through a needs assessment based on evidentiary hearings.

A11. Encouragement of Renewables

a. How shall renewables be encouraged in a competitive environment? Please discuss such mechanisms as a requirement that X percent of energy sold in the competitive market must come from solar sources.

AUIA cannot conceive how a percentage sales requirement could be enforced in a competitive market. It presumes that solar resources exist somewhere to satisfy the requirement and that someone along the way will absorb the cost differential between solar and market-priced energy. The most plausible way to "encourage" renewables in a competitive environment is through state or federal tax incentives to the consumer, a method which has passed from favor and which is beyond the Commission's authority. As an alternative, it might be possible for the Commission to provide universal price incentives to consumers through rate-setting at the DISCO level. AUIA does not favor this approach because it distorts market conditions.

b. How could progress in encouraging renewables be measured?

By tracking and measuring energy displaced by renewables.

c. How could a renewables program be enforced by the Commission?

We do not see how a renewables program or objective aimed at electricity providers could be "enforced" in a competitive environment any more than you could "enforce" a program in support of nuclear energy or coal.

A12. Pooling of Generation and Centralized Dispatch of Generation or Transmission.

a. Should pooling of generation or centralized dispatch of generation or transmission be mandatory or voluntary?

Both pooling and centralized dispatch should be voluntary. AUIA pretends no particular expertise in this subject, but we are generally familiar with most of the system configurations that are under consideration. As utility investors, we favor the continued integration of production and delivery components and are opposed to forced divestiture of any utility plant. Part of our concern relates to system reliability which we believe is better assured when the owner of the production units and the transmission is in control of his own property. We have not been convinced that mandatory pooling or centralized dispatch will improve system efficiency, nor are we yet persuaded that these are required protections from the vague notion of market power.

b. What technical requirements will be necessary to ensure reliable and efficient use of generation and transmission resources? Please propose specific requirements, if possible.

AUIA is not prepared to comment on technical requirements for the use of generation and transmission resources.

A13. Non-Public Service Corporations. *How shall non-public service corporations such as municipal utilities be involved in a competitive market?*

Along with stranded investment, this qualifies as one of the most difficult issues involved in creating a competitive market in Arizona. The operative issue is not the inclusion or exclusion of municipalities per se but the fact that the state's largest market is split under a territorial agreement between APS and SRP. APS is a public service corporation regulated by the ACC and SRP is a municipal corporation and federal reclamation project regulated by its own publicly elected board of directors. The Arizona Constitution excludes municipalities from regulation by the ACC.

APS and SRP have coexisted and competed for customers in the same market area for many years, but they have done so with a clear delineation of service territories and largely without the threat of external competition from other electric providers. With the advent of retail competition, each company's territory would be open to the other and to outside energy marketers. Yet, under current circumstances each company would operate under a completely different regulatory framework.

AUIA believes that every utility and its customers should have an opportunity to share in the benefits of competition. However, a competitive market also must be free of distortions of the kind that could result from conflicting regulatory systems. It is at least worth noting that SRP and APS also share the greater Phoenix market with Southwest Gas Corporation which also has a stake in the resolution of these differences.

These domestic issues are similar to the discrepancies that will surface between Arizona and other jurisdictions. For example, Arizona utilities may find themselves competing against outside providers which aren't regulated by anyone. For another, native utilities should not have to compete at home with producers from states that don't provide reciprocal opportunities to compete. And finally, Arizona utilities that pay hundreds of millions of dollars in property taxes or in lieu contributions will find it more difficult to compete against utilities that pay little or nothing in property taxes in the states where they are located.

In the last analysis, the differences in status between PSCs and non-PSCs will have to be addressed in concert by the Commission and the Arizona Legislature. It is also very possible that the regulatory status of all electricity providers will be redefined by federal legislation when the U.S. Congress brings industry restructuring to the front burner.

Hopefully, the Arizona utilities will come to an understanding that will be acceptable to state lawmakers and to the Commission. In the meantime, AUIA believes that the Commission must anticipate and plan for an environment which will include SRP in the competitive mix.

A14. Conditions for Returning to Utility Service After the Conclusion of a Pilot Program. *If a pilot were adopted, please indicate what conditions are appropriate for returning to utility service after the conclusion of the pilot.*

As we indicated earlier, AUIA favors a phased-in transition to competition rather than a pilot program. If a pilot program were instituted, it should protect the host utility from stranded investment. This would probably require either a) that the pilot is conditioned on a need for new capacity or b) that an exit fee be imposed on departing customers. Under certain conditions a re-entry fee, including a capacity charge, might be applicable.

A15. Conditions for Returning to Utility Service (in an Ongoing Competitive Market). *Please indicate what conditions (if any) are appropriate for returning to utility service if a competitive market is on-going.*

As we indicated above, AUIA is concerned primarily that the comings and goings of customers in a competitive market are revenue neutral in the sense that any stranded investment is adequately compensated. They also should not disrupt the utility's construction programs and its planning for capital requirements to the detriment of other customers or investors. If an exit fee has not been imposed previously, a returning customer should be required to reclaim utility service under a long-term contract with economic provisions that capture any costs that are attributable to the break in service and its restoration.

A16. Administrative Requirements

a. A utility may require consumers obtaining generation from another entity to adhere to reasonable scheduling notification requirements, accept reasonable delivery points, adhere to reasonable metering requirements and accept reasonable remote control requirements for interruptions or other purposes. Please specify what you consider to be reasonable.

AUIA is not prepared to comment on the requirements that would be reasonable for a host utility to impose on a wheeling customer, but we will offer two ancillary comments: 1) All or most of these issues may be contractual matters, but it is also possible that they may be tarified, either as DISCO services or simply to establish some uniformity in terms of their impact on host utilities; 2) In any case, it will be useful to clarify where the jurisdiction lies on these matters as soon as possible.

b. How should the utilities identified in Section A1 notify their customers of the adoption of a competitive program by the Commission?

In the case of a pilot program or a phased-in transition, it should be relatively easy for the utilities to provide their affected customers with a clear description of the program by direct mail and personal contact. In order to prevent confusion and unreasonable expectations, the utilities will also have to communicate with the general public, their investors, the financial community and unaffected customers. It may be that advertising should be included in the communications mix.

A17. Impacts on Other Utility Customers. *Please indicate how adverse impacts on rates or service quality for utility customers not participating in the competitive market could be minimized.*

- We assume that rate impacts would arise mainly from cost-shifting due to revenue losses caused by departing customers or possibly from deep discounts offered to large customers in order to keep them on the system. The impact of stranded investment attributed to departing customers would be minimized by the use of exit fees or other non-bypassable charges.

While discounts may result in some cost-shifting, they do help to reduce the impact that could be created by customers who are able to leave because they have a viable alternative to continued utility service.

- AUIA assumes a distinction between service quality and system reliability. Limited competition should not affect service quality for non-participating customers. In a broader competitive market, poor service might result from declining operating revenues or the entry into the market of shoddy performers. During the transition the Commission will probably have to enforce service standards, but as the regulatory compact unravels, service quality will be regulated increasingly by choice in the marketplace.

A18. Reporting Requirements for All Sellers of Electricity to End Users. *Please indicate what reporting requirements (to the Commission) are appropriate and who should file reports.*

Although it may not be intended, this question has a broad reach in that reporting requirements can be interpreted in several ways, depending on how the utility business is organized and regulated. Here is one approach:

Energy: Energy providers should be required to report the same information that is required of regulated utilities and utility holding companies, including but not limited to company ownership, financial structure, energy resources, tariffs, aggregation, customer and load data and terms and conditions of major transactions. Contract forms should be filed with the Commission. As competition unfolds, the ACC should be the repository of data about the state's energy requirements and how they are being met. And as competition extends to smaller and less sophisticated users, the Commission is the logical agency to watch over consumer interests.

Distribution: We assume that distribution will continue to be carried out by the companies that do it now and that they will do so within the existing regulatory and reporting framework. That is, by public service corporations regulated by the Commission and by non-PSCs governed by other public boards. It remains to be seen whether some services will continue to be bundled in the distribution package or may be offered competitively as energy or customer services.

Energy & Customer Services: To the extent that these services are offered by certificated energy companies or by DISCOs within their service areas, they do not create any additional reporting requirements. If they are offered independently from energy sales and distribution, they probably do not invite Commission jurisdiction. In some instances the ACC may have to decide whether to impose its judgment on the disposition of ancillary services which affect system reliability and safety.

A19. Certificates of Convenience and Necessity. *Please comment on whether competitive sellers who supply electricity to an end user must obtain a Certificate of Convenience and Necessity from the Commission (unless the seller already has an applicable Certificate). Please describe whether any conditions on the certificate would be necessary.*

AUIA asserts that any entity which seeks to sell electricity to an end user in Arizona must submit to the jurisdiction of the ACC and obtain a certificate of convenience and necessity. Under normal circumstances this requirement would not extend to entities which are exempted from regulation by the Arizona Constitution. However, any organization, exempt or otherwise, which seeks to sell electric service in the certificated territory of a public service corporation must submit to ACC jurisdiction with regard to that activity.

The Commission may not be able to abrogate its regulatory authority even if it wants to without an amendment to the Constitution. But if this were not so, there are many reasons for Commission oversight at least during the transition to a competitive market for electricity. Making and delivering electricity safely and reliably to millions of users is a far more serious and complicated business than providing long distance telephone service which is the only monopoly service that has yet been deregulated in the United States.

The need for Commission oversight includes the following:

- To regulate distribution and some associated services;
- To ensure system reliability;
- To monitor the financial integrity of utility systems, including the disposition of utility assets;
- To protect the interests of utility investors who are owed fair treatment under the terms of the regulatory compact;
- To protect the interests of customers who are not participants in the competitive market;
- To oversee marketing and pricing programs as they are developed for each customer class;
- To set and enforce service quality standards;
- To enforce safety requirements;
- To regulate universal service (provider of last resort);
- To review and approve public financial offerings;
- To coordinate resource planning.

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